EX PARTE OR LATE FILED

ORIGINAL

MCI

MCI Communications Corporation

1801 Pennsylvania Avenue, NW
Washington, DC 20006
202 887 2993
FAX 202 887 2676
Keith.Seat@MCI.Com

Keith L. Seat
Senior Counsel for Competitive Strategies
Federal Law and Public Policy

March 4, 1999

VIA HAND DELIVERY

Ms. Magalie Roman Salas, Secretary
Federal Communications Commission
The Portals
445 Twelfth Street, S.W.
Washington, DC 20554

Re: Ex Parte Submission in CC Docket No. 96-98, CCBPol 97-4 Petition of MCI for Declaratory Ruling that New Entrants Need Not Obtain Separate License or Right-to-Use Agreements Before Purchasing Unbundled Network Elements

Dear Ms. Salas:

On Thursday, March 4, 1999, the two attached letter were sent to Michelle M. Carey, Jake E. Jennings, Donald K. Stockdale, Jr., Douglas Galbi and William J. Bailey of the Common Carrier Bureau. The first letter, from the undersigned, withdraws MCI's preemption claim in the above action. The second letter, from Michael D. Pelcovits, Chief Economist of MCI WorldCom, provides an economic analysis of cost recovery for activities related to the introduction of competition, including intellectual property "adder" costs.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(2) of the Commission's rules.

Sincerely,

Keith L. Seat

cc: Michelle M. Carey
Jake E. Jennings
Donald K. Stockdale, Jr.
Douglas Galbi
William J. Bailey

MCI Communications Corporation
1801 Pennsylvania Avenue, NW
Washington, DC 20006
202 887 2993
FAX 202 887 2676
Keith.Seat@MCI.Com

Keith L. Seat
Senior Counsel for Competitive Strategies
Federal Law and Public Policy

March 4, 1999

By Fax and Hand Delivery

Michelle M. Carey, Esq.
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: CC Docket No. 96-98; CCBPol 97-4 Petition of MCI for Declaratory Ruling that New Entrants Need Not Obtain Separate License or Right-to-Use Agreements Before Purchasing Unbundled Network Elements

Dear Michelle:

The Commission has asked that MCI confirm in writing its willingness to withdraw the preemption claim in the above-captioned action. Because it is our understanding that the Commission will issue rules regarding intellectual property, and because we have no reason to expect that the states will not comply with those rules, we believe the preemption claim is unnecessary and MCI hereby withdraws it without prejudice. We reserve the right to bring a preemption petition at a later date, however, if a given state does not comply with the FCC's rules.

Thank you for your assistance in this matter. Please feel free to contact me with any questions or concerns.

Sincerely yours,

Keith L. Seat

cc: Jake E. Jennings
Donald K. Stockdale, Jr.
Douglas Galbi
William J. Bailey

MCI Telecommunications Corporation
1801 Pennsylvania Avenue, NW
Washington, DC 20006
202 887 2721
Fax 202 887 2215

Michael D. Pelcovits
Chief Economist

March 4, 1999

By Fax and Hand Delivery

Michelle M. Carey, Esq.
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: CC Docket No. 96-98; CCBPol 97-4 Petition of MCI for Declaratory Ruling that New Entrants Need Not Obtain Separate License or Right-to-Use Agreements Before Purchasing Unbundled Network Elements

Dear Michelle:

At our meeting of January 15, 1999, we discussed recovery of intellectual property ("IP") "adder" costs, i.e. incremental costs that an incumbent local exchange carrier ("ILEC") claims must be paid in order to extend an existing license agreement with a third party vendor to cover the use of unbundled network elements ("UNEs") by competitive local exchange carriers ("CLECs"). We explained that even if it could be proven that such an adder is truly required, the cost of the adder should be recovered on a proportionate basis from all users of the network elements, both the ILECs' retail customers and the CLECs (which in turn would pass on these costs to their retail customers). In our opinion, this approach is fully consistent with the TELRIC principles applied to the pricing of UNEs, which were established by the Commission in its August 1996 Order on Interconnection, and is necessary to achieve competitive neutrality and nondiscriminatory access to network elements.

As an initial matter, it is important to note that we believe existing IP licenses from third party vendors should be construed to protect CLECs, as customers of the ILEC. However, neither the vendors nor the ILEC has any incentive to interpret their license agreements to protect CLECs; a vendor would always like additional royalties, and it is in the ILECs' interest to raise CLECs' costs and risks. To interpret the existing agreements as not protecting CLECs would raise total costs for the system and for ratepayers as a whole. On the other hand, a requirement that additional IP costs be recovered on a proportionate basis would give ILECs the incentive to construe the agreements properly to protect CLECs, thereby lowering costs for all ratepayers.

Moreover, CLECs generally are already paying for IP rights in UNE rates, which must be based on the ILEC's forward-looking costs.[1] Third, the vendor's recompense is generally a flat rate that is independent of any particular volume of use and should not be assumed to increase as a result of CLEC use of UNEs. Finally, it should be noted that the outcome of this issue may significantly impact the competitive environment and influence CLEC decisions about full scale launches of competitive local service. The purpose of this letter, however, is to focus on how costs should be allocated if an IP adder is determined to be necessary.

At our meeting, we agreed to provide a fuller economic analysis of cost recovery for the activities related to the introduction of competition, and specifically to analyze any differences in the types of costs that fall in the general category of "competition-ready" costs. This letter provides that analysis, beginning with a brief discussion of basic principles.

Underlying Principles

Competition Benefits All Customers. The starting point for our analysis is the Telecommunications Act of 1996. The Act's goal is a major evolution in the structure of the local telecommunications market: from a legally sanctioned and protected monopoly to a thriving competitive marketplace. This change will benefit all customers, whether or not they ever take service from one of the new entrants. As illustrated by the opening to competition of the long distance market, the benefits of competition were (and are) shared by all customers, even though the market share of the incumbent fell very gradually after competition was introduced. New entrants led the market in cutting prices and providing innovative services, forcing AT&T to lower its prices and improve its services.

Therefore, if there are certain costs of making the local exchange "competition-ready," these costs should not be imposed only on the new entrants and their customers. Rather, the costs of transforming the industry should be borne by all carriers and their customers, who are the beneficiaries of competition. Spreading these costs is not only equitable, but is essential to foster competition. If these costs are imposed entirely or disproportionately on the new entrants, they would constitute a major barrier to entry, and potentially undermine development of the competitive market.[2] So the simple answer to the question of how to recover the costs of the IP adder, or any other cost of making the local exchange competition-ready, is very simple: these costs must be spread proportionately across all users of the local exchange.

Cost Causation. According to economic theory, prices should be set at marginal costs to yield an optimal utilization of scarce resources. This allows consumers to choose

[1] If an ILEC failed to raise the cost of IP rights in the calculation of UNE rates, it would be improper for the ILEC now to attempt to shift those costs directly to CLECs rather than seeking to adjust its UNE rates in due course.

[2] These costs would come under the widely accepted definition of a barrier to entry, namely a cost that must be borne by the new entrant that the incumbent does not have to bear.

between alternative uses of resources to maximize their welfare. For example, if the installation of a new residential telephone service requires a premise visit by a telephone company technician, the customer would be the causer of the costs of the visit, e.g. the labor time, motor vehicle usage, etc. If these resources, or similar resources, could be used to provide an alternative service – such as to install cable television service -- then the prices for the two services should be the same, so the consumer can choose which service he most desires. This will lead to an efficient allocation of resources. If, instead, a service is priced below marginal cost, then the consumer will consume too much.[3] Conversely, if the service is overpriced (priced above marginal cost), then the consumer will consume too little of the service.

This discussion implies that the efficiency benefits of imposing costs on the "causer" will accrue to the extent that the marginal costs of serving that customer are identified and passed through to the customer. In the example above, the cost of a premise visit by a technician may be easily identified and passed on to the customer, thus creating a more efficient use of resources.

Static vs. Dynamic Efficiency. The discussion of economic efficiency has thus far been limited to what is termed "static economic efficiency," which is defined as the achievement of an outcome where it is impossible to improve economic welfare by reallocating the usage of scarce resources. There is a second concept in economics of "dynamic economic efficiency," which means the achievement of outcomes over time that allow for fully exploiting technological changes that reduce the cost of production, facilitate new and improved methods of production, or foster the rapid introduction of new products and services. Technological change effectively increases the productive potential of firms for any given amount of scarce resources. Dynamic economic efficiency is attained if such production potential is fully realized. Since competition is much more likely than monopoly to yield dynamic efficiency, the Commission must be concerned with too narrow a focus on the static efficiency benefits obtained as a result of applying the cost causation principle.

In deciding policy on recovery of competition-ready costs, the Commission must balance the static economic efficiency benefits of cost causation with consideration of the long term dynamic benefits from competition.

"Competition-Ready" Costs

We next analyze whether there are differences in the economic characteristics of different types of "competition-ready" costs that the Commission may wish to consider in establishing its policies on cost recovery. We will discuss three categories of competition-ready costs: (1) collocation costs; (2) operations support systems costs; and (3) IP adder costs.

[3] If network externalities exist, price would have to be below marginal cost for economic efficiency to be realized.

Collocation Costs. First, consider the costs incurred by the ILECs in preparing and providing collocation space in their central offices for the CLECs, which may include the costs to rearrange equipment, install new wiring or environmental controls, or establish security arrangements. The ILECs claim that the CLEC is the "causer" of these costs and that basic ratemaking principles dictate that the CLECs should be required to pay all of the costs related to collocation, based on the static cost causation principles discussed above.

Indeed, some collocation costs may be related to the marginal cost of serving a particular CLEC. To take an extreme case, assume that the cost of preparing space for collocation is directly proportional to the amount of space provided, at a cost of $50 per square foot. In this case, the marginal cost imposed by a CLEC ordering 100 square feet of collocation space is $5000. Charging the CLEC $5000 for the space will yield static efficiency benefits.

However, imposition of collocation costs on the CLEC could distort dynamic efficiency. Suppose the ILECs do not incur costs to serve their own customers that are similar to the collocation costs imposed on the CLECs. This may be a result of the way in which the central office planning and provisioning process works. For example, the cost of outfitting the building when it is first built may be much lower than the costs of "upgrading" it for collocation. As a result, if the Commission looks only to static efficiency principles, it may well impose entry barriers and retard competition. Therefore, the Commission must balance the potentially competing objectives of static and dynamic efficiencies in resolving this issue.

OSS Costs. The case we consider next is where an ILEC's OSS system must be modified to accommodate competition, such as through the use of UNEs. OSS systems were initially developed by ILECs for a single vendor world, where only the ILEC's employees could secure on-line, electronic access to the systems needed to order and provision services, along with the related pre-order, maintenance and repair, and billing functions. In order to provide UNEs to CLECs on a nondiscriminatory basis or otherwise enable local competition, these OSS systems must be modified to give CLECs electronic interfaces with the ILECs' systems.

Although OSS modification costs are similar to collocation, in the sense that the CLECs can be said to cause these costs, there are fundamental differences between the two that would eliminate any static efficiency benefits from recovering OSS modification costs disproportionately from the CLECs. The general principle of cost recovery presented above is that the price to the cost causer should be set equal to marginal cost, so that the user will be guided by the "invisible hand" to purchase an efficient amount of the service. In the case of OSS modification costs, however, the decision of the individual CLEC to use the modified OSS does not cause the ILEC to devote additional resources. Rather, there is a one-time decision whether to modify the OSS systems to accommodate competition. Once that decision is made and the OSS systems are modified, there is no

incremental cost of increasing the number of users or uses of the system.[4] Hence, the marginal cost of the additional usage is zero, and the price per user or usage of the modified OSS system that would yield static economic efficiency is zero. Imposing the cost of the modification disproportionately on the CLECs (via a usage or flat charge) would discourage use of UNEs, even though the benefit from that incremental use would exceed the costs.[5] Thus, in the case of these OSS costs, there is no tradeoff to be made between the two policy goals (static versus dynamic efficiency), both goals are served by recovering OSS costs on a nondiscriminatory basis from all customers (of both ILEC and CLECs) that use the ILEC network.

IP Adder Costs. Finally, consider the IP adder costs, where the application of the cost causation principle has been suggested by the ILECs. The argument has been made that the CLECs are the cost causers, because if the CLECs did not demand the UNEs, then the ILECs would not have to pay additional IP costs. While this point has a surface appeal, it bears no resemblance to the conventional case of cost causation, in which there are good economic reasons to impose costs on the "cost causer."[6] In contrast to the conventional case, the IP adder costs do not represent the opportunity costs of any resources used to produce or increase production of a telecommunications service, for the simple reason that the IP adder does not involve any production activity. The IP adder "costs" are not a cost, but rather a transfer of rent between the ILEC (and its ratepayers) and the property owner.[7] Passing these cost on to the CLECs does not bring prices closer to marginal cost and will not lead to a better allocation of scarce resources.[8] Thus, unlike the case of collocation costs, the Commission faces no tradeoff between static and dynamic efficiency: both goals are served by spreading the IP adder costs across the largest number of customers.

The nature of these IP costs adds an additional dimension to the cost recovery issue. As noted above, if the costs are imposed only on the CLECs, the ILECs will have no incentive to negotiate a lower price. Rather, the incentives of the two parties to the negotiation – the ILECs and the equipment vendors – will be the same: to obtain a higher

---

[4] This refers solely to the cost of developing or modifying the software and hardware to operate the OSS systems. If additional usage of the system requires additional resources (more hardware or technicians on an ongoing basis), then these costs are being "caused" on an incremental basis by the user and the price structure should include a charge for usage to maximize static efficiency.

[5] Apportioning OSS costs among the CLECs would not increase efficiency because there would be no way to determine ex ante the number of CLECs that would use the OSS system or the share of the benefits that each would realize. Moreover, imposing a fixed charge on each CLEC for use of the OSS systems would result in fewer than the optimal number of CLECs entering the market in the long run.

[6] The arguments made above that increased consumption of new OSS systems does not increase costs also applies in the case of IP costs, although the point is moot in light the fact that the adder costs themselves are not "true" economic costs.

[7] There are significant economic issues involved with the impact of the compensation to property owners on the incentives of the owners to create new property. These issues do not arise in the case of the adder costs, because we assume policymakers will require that all future contracts between ILECs and vendors must explicitly allow for use of the IP by the UNE customers. The IP adder issue is a one-time problem that will not affect the property owners' incentives. Nor does this discussion in any way concede that past or current contracts between ILECs and vendors do not at least implicitly permit IP use by UNE customers.

[8] We are ignoring the time spent by the parties negotiating the IP adder. These should be trivial relative to the total costs at stake.

price. One can imagine a negotiation where the two parties keep bidding up the price, unrestrained because neither will be paying the bill. The problem is further compounded by the difficulty that regulators would have in judging whether the cost was "reasonable." In other circumstances, regulators can often assess whether the cost elements of a service, such as the labor time and material costs, justify the price. In the case of IP adder costs, where there are no actual resources used to provide the "service," regulators lose their ability to analyze cost data to judge the reasonableness of the charge.

In conclusion, imposing the IP adder costs only on the CLECs will have one of two deleterious effects on the market. At best, it will distort the market by raising the CLECs' costs and prices, and thereby causing consumers to make inefficient choices between CLEC and ILEC services. At worst, it will prevent altogether the development of local competition using unbundled elements.

* * * * *

I hope you find this information useful. If you have questions or would like additional information, please do not hesitate to contact us.

Very truly yours,

Michael Pelcovits, PhD
Chief Economist
MCI WorldCom

cc: Jake E. Jennings
Donald K. Stockdale, Jr.
Douglas Galbi
William J. Bailey